RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**
P.O. Box 1759, La Jolla, California 92038
36 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

February 8, 1978 **LETTER 721**

Jan. 27, DJIA 764.12; PTI 724; A-D Ratio –22.31
Feb. 3, DJIA 770.88; PTI 738; A-D Ratio –21.61

THE MARKET: In the next section of this report, I indulge in a bit of rambling, fantasy and rumination about the stock market. But here at the start of this Letter, I want to stick pretty close to what that chart below is saying. What we see here, in my opinion, is a rather ominous picture for the longer term–with the "potential" for a rally over the shorter and perhaps even for the intermediate term.

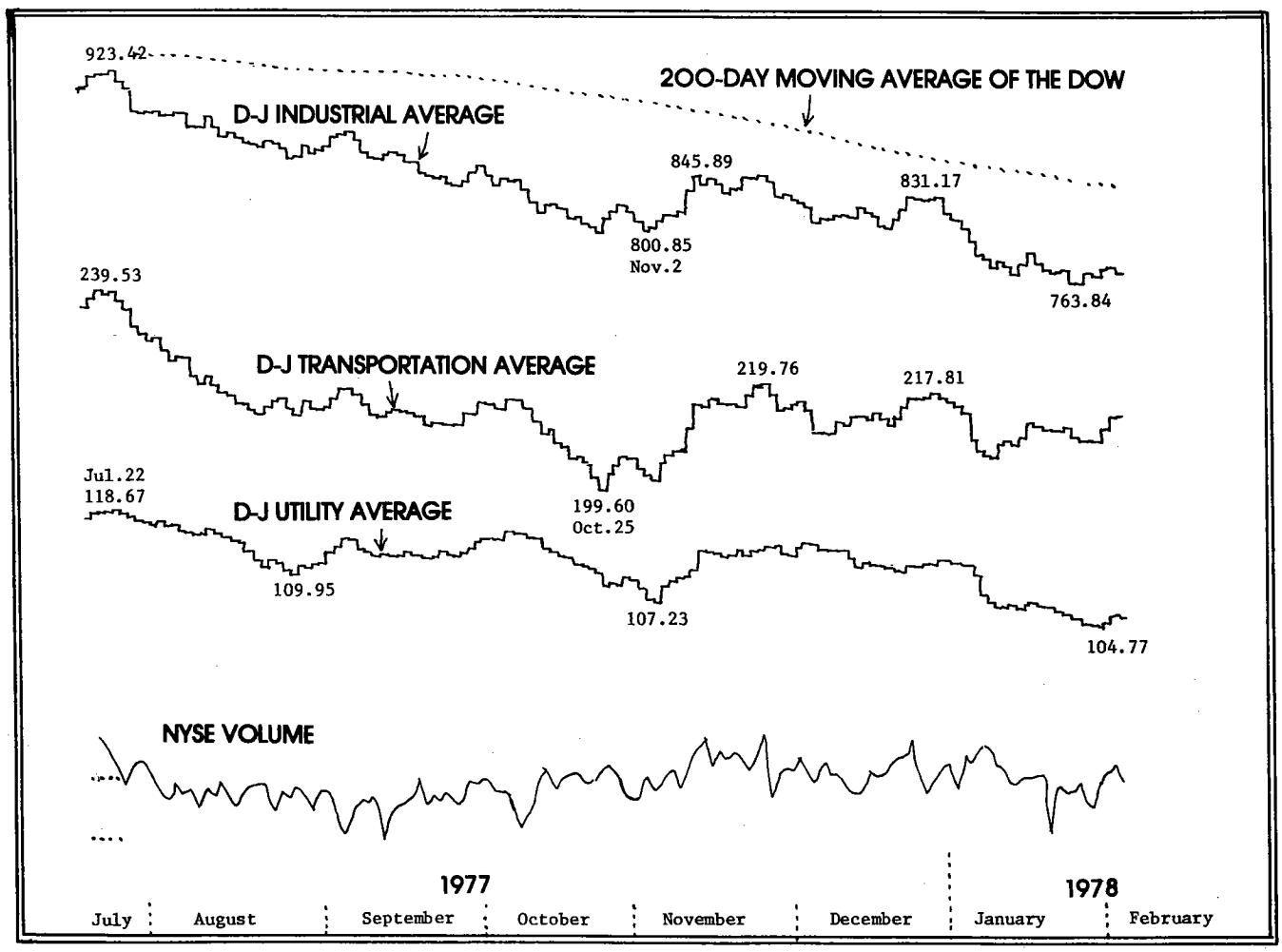
In the twenty years that I've been writing these reports, I've always carried a daily chart of the D-J Industrial and Transportation Averages on page 1. In this Letter I've made an addition– I've included the D-J Utility Average for the first time. I don't know whether I'll continue this practice, but I am considering it.

The D-J Utility Average was a late-comer to the stock market: it was introduced in 1929. Pioneer Dow Theorists such as William Hamilton and Robert Rhea seldom used the Utility Average in their thinking, and they almost never mentioned the Average. The reason is that they had *too little history* of the Utility Average and therefore too little experience with it.

I've studied the action of the Utility Average for years, and I've often referred to this Average as a bellwether. It tends to lead the market in primary movements. For instance, in 1972 the Utility Average topped out on November 24 at 124.14. It *didn't participate* in the early 1973 final up-thrust. That little warning by Utilities proved to be one of the signals for the 1973-74 crash. Again, the Utility Average recorded its low on September 13, 1974 at 57.93, **two months before** the final Industrial low. That signal was one of the technical phenomena which called the turn for the new bull market.

On July 22, 1977, the Utility Average struck its 1974-77 bull market peak (see chart below) at 118.67, then turned down. A low point was hit in August at 109.95. A second low was recorded in November at 107.23. In recent days the Utility Average has broken below the 105 level to record a one-year low. At this point, it seems to me that the Utility Average is again leading the way for the market, and the way is down.

Since the Utility industry is sensitive to money rates, energy needs, the availability of massive financing, the whims of regulatory agencies and the level of consumer and industrial activity, the action of the Utility Average is not to be taken lightly. At any rate, I interpret the profile of the Utilities on the page 1 chart as a warning that over the longer term this market is headed lower.



Next, we come to the action of the Industrials, the Transports and the general market. In the last Letter I called attention to the fact that the Transports had stubbornly refused to confirm the Industrials on the downside. A downside confirmation by Transports would entail a violation of the 199.60 level, and that has not yet happened. I also said that my figures showed a very large plurality of declining days over advancing days, based on the advance-decline ratio. As of now we still have only 8 up-days out of the last 21 days. This kind of lop-sided action usually calls for a period of even-ing up, and in some cases it has signalled the beginning of a good rally or even a secondary (upward) correction.

And the market did "pop up" from its recent low, a low identified by the 763.34 Dow closing of January 26 (see p. 1 chart). But on the rally we immediately ran into outstanding Dow weakness and a little non-confirmation on February 2. Note that the early-February rally saw the Transports better their January 18 peak of 212.07, a move **unconfirmed** by the Industrial Average (a confirmation would have entailed an Industrial bettering of its January 18 peak of 786.30).

As matters now stand, I would term this market "unappetizing," to say the least. The bond market remains sloppy to weak, the public (as measured by odd-lot transactions) is complacent if not downright optimistic. On the plus side, it is true that neither the A-D ratio nor the Transports have yet violated their October lows.

So where does this leave us? My technical work indicates that this market has most definitely not generated an over-sold condition since late-1976. The market moves from SEMI over-sold to over-bought, back to SEMI over-sold, and back to over-bought. In other words, this market **refuses to develop enough bearishness** to take the indicator to a true over-sold condition. The longer that situation continues, the bigger the ultimate over-sold when it finally arrives. Our job is to stay out and to remain patient.

CONVERSATION: It was formerly held that a man who "talks to himself" is on the way to the madhouse. But more recently, psychiatrists have realized that all things have two sides–that nothing is truly "singular." Thus there is the proton and the electron,the light and the dark, the right and the wrong, the hot and the cold, the positive and the negative. The Chinese recognized this phenomenon centuries ago with their concept of yin-yang, the completed circle composed of two halves (symbolic of all matter), with each half containing a bit of the other.

This concept can lead to all kinds of trouble, because men are arrogant and fearful, and they like to think in terms of absolutes. "He's a Facist," "It's totally rotten," "That's perfect." But the fact is that everything and everyone has two sides. These two sides are in a continual struggle with each other (although the struggle is often a friendly one). For instance, we have a soft side and a hard side, an aggressive side and a passive side, a mature side and a childish side, a loving side and a hating side.

Dr. Frederick Perls, the brilliant psychiatrist who discovered Gestalt therapy, claimed that many people are almost completely out of touch with their various opposing sides. These "split" people can be very sick, and the worst of them are incapacitated and are known as schizophrenics. On the other hand, some few people are amazingly in touch with their various sides, and we term these people "geniuses." The geniuses are extraordinarily effective. But the genius syndrome can happen to any of us. When we finally "meet" the two sides of ourselves, and when the two sides establish a working relationship, we find that we become very efficient, effective, acute. We discover that our lives move, we accomplish things, we get things done.

Most people, noted Perls, have access to about 5% or 10% of their true potential. The genius has access to perhaps 15% of his (or her) potential. Thus, all roads lead to Rome, and all therapy and growth (hopefully) leads to INTEGRATION, the coming together of the various "psychic strangers" (the alienated parts of ourselves).

This lengthy preamble is not without purpose, since it is my way of proving to myself and my subscribers that I am not mad when I indulge in a dialogue with myself. These conversations go on all the time within my cranium, although I must admit they usually occur at around 3 a.m. At any rate, my latest self-dialogue is between Rock Russell, who has a habit of feeling certain about things–and Harvey Russell, a much more circumspect fellow, a more sophisticated type who tends to see the "other side" of all arguments. As a matter of fact, the more adamant Rock is, the more Harvey searches for the cracks in Rocky's ideas.

Rock: You know, this whole bear market has been one *unorthodox* devil. Look at what's happened. The Dow topped out in September, 1976, but the Transports hit their peak in May, 1977. Then in July the A-D ratio and Utilities topped, and finally in September the S&P 500 hit its peak. Instead of the usual final rally in the Dow prior to a top, the Dow was the only indicator in this bear market to provide an early warning.

Then, the recent Dow Theory bear signal was certainly unusual in that the Industrials gave their part of a bear signal in March, 1977 while Transports did not confirm until October (at which point Industrials were down over 200 points).

Again, we have witnessed one of the most dramatic cases of price-breadth divergence in stock market history with Industrials turning down in September, 1976, while the advance-decline ratio continued to advance. It wasn't until July of 1977 (10 months later) that the two indicators finally got back in gear, and of course the gears were synchronized to the downside.

I could go on and on with the unorthodox comparisons, but the latest example must certainly be the bank discount rate rise. Here we see the third boost occurring in January, 1978 (to 6½%). The third boost meant that Edson Gould's "three step-and-stumble rule" has been triggered with the Dow already down 24%. And, of course, the usual sequence is for the stumble rule to be set off well before the ultimate Dow top.

Again, the big Utility-Bond break came only a month ago (see last Letter) with the Dow having already lost 250 points. The Utility and Bond Averages usually give their warning early in a bear market. And to make the whole picture even more unorthodox, we see the Primary Trend Index just topping out now, with the Advance-Decline ratio still hanging on. Furthermore, the AMEX and NASDAQ indices have not really broken down yet.

Harvey: Very interesting Rock, but couldn't we make a hopeful case out of all this. We see this extensive damage to the Dow stocks, but the secondaries are, in many cases, still hanging on. The Dow has been declining for 17 months, and that incredibly persistent weakness hasn't swept across the board yet. Couldn't we term that an important element of strength in this market?

Rock: Sure you could call it strength, but I call it misplaced hopes. There's never been a Dow slide like this, that has not hit the rest of the market **in due time**. And that's what I think we are going to see during 1978–a smash in the whole non-Dow segment of the market. The *longer* the rest of the market holds out–the bigger the smash, in my opinion.

Harvey: Well, I'm glad you added "in your opinion." But what was the big deal you were making out of this 'unorthodox bear market'. I gather you were trying to make some point. What was it?

Rock: My point, Harvey, is that I expect this bear market to *continue* on its unorthodox track. You see, Wall Street has bred too many smart boys, geniuses, mavens, over the last five to ten years. They can all think and read, and they all know how normal bear markets work. But when everyone is on to something in the stock market, then the market changes the game, it messes around with the rules. Because don't forget, Harvey, the market is out to bust our pocketbooks. Very few people make money in Wall Street over the years, which means that most people (the rest) lose money. There's a good reason for that, and the reason is that the market is always in the business of proving that there is no free ride in the investment world.

Harvey: That's one place where we do agree, Rock, and I will say that the market does a beautiful job in proving that there is no good fairy running Wall Street.

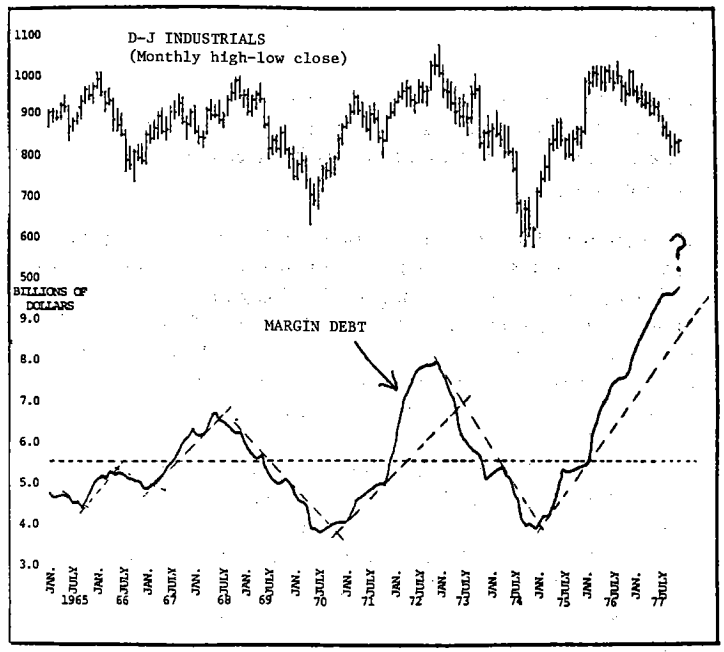
Rock: To continue, everyone is now into cycles, the four-year cycles, the 12-week cycles, the 9-year cycles, the easy little indicators. Well, that got me thinking. The "8-years" have always been good years, as far back as we have market records, and by 8-years I mean 1888, 1898, 1908, 1918, right up to 1958, 1968. And I have a feeling that most people deep in their hearts think 1978 is going to be (or at least will end up) a good year. Well, I'm beginning to wonder about that. In fact, the longer this market holds on to its optimism, or at least its complacency, the more I'm going to doubt that 1978 is going to wind up a winner.

Harvey: C'mon, Rock. The Dow has been going down for 17 months, the rest of the market and the bonds are beginning to break down with the Dow, and you think this rotten action could carry through for another year? I'm no perpetual optimist, but that sounds like too bearish a scenario for me to swallow. But go on, let's hear it all.

Rock: I keep thinking that we haven't had a really major low, a really important buying spot if you want to call it that, since 1974. I've never ever seen a span of more than four years in the stock market which failed to produce a major buying area. And that points to 1978 as a year for a "big bottom." Now to get a major bottom, we've got to have an across-the-board smash in the stock market. Yeah, I know, the Dow has lopped off 250 points and dropped 24%–but that hasn't been enough. You've got to get massively over-sold to produce a bottom, and you get those massive over-sold areas when the **breadth** collapses.

Harvey: I can't argue with you there. But what's so unorthodox about 1978's producing a breadth slide and an accompanying over-sold situation?

Rock: Nothing, except that the *longer* this market holds up, the more likely that a breadth collapse will occur later this year.



Look at what's happening on this chart (chart courtesy of Ned Davis of J. C. Bradford Co., Bradford Building, Nashville, TN 37219). Margin account totals on the NYSE are now at a record $9.7 billion. In the past, margins peaked with the Dow and they headed down with the Dow. But this time, despite the 17-month drop in the Dow, margins have been pushing to new highs. It's unprecedented. And think of it–all these guys are willing to hold margin debt with interest rates going up. Why it's costing them 8 3/4 to 9½% and more to hold these margins! How's that for optimism!

Then let's look at odd lot transactions, which are a good gauge of what the public, the little guy, is doing in the market. The figures show that the odd-lotter has cut way back on his selling of late last year. Whereas the odd-lotter was selling an average of about 220 shares for every 100 purchases during the fourth quarter, he's now selling about 150 shares for every 100 purchased. That's a real swing in sentiment, and I think it's misplaced as far as the market is concerned.

Harvey: Rock, the broader market indices have come down some. The S&P 500 is down over 17% from its 1977 peak, the NYSE Composite is down over 15%. Maybe that's enough to discount people's doubts. And furthermore, business is still pretty good, cars are still chugging along bumper to bumper on the freeways, they're still building houses all over the landscape. I don't know, why do you think the market has to go lower?

Rock: OK, I'll give you some further views of what I think the market is looking at and discounting. I think the market is discounting real trouble on the money front. The debt of this nation is simply running wild. I don't care whether you're talking about stock exchange debt, individual debt, housing debt, city debt, county debt or Federal debt, it's all too high. And by too high I mean it's coming to the point where it's damn near unsustainable.

The bond markets and the Utility Average have been hinting of that–by buckling. The money markets have reached the point where they can't handle any more debt issues at prevailing prices. So money instruments are being marked down in an effort to lure new buyers in. Money is now leaving the banks and the savings & loans as the US Government comes out with fatter coupons (yields) on its own debt paper. On top of this, the average American is beginning to feel the squeeze on his

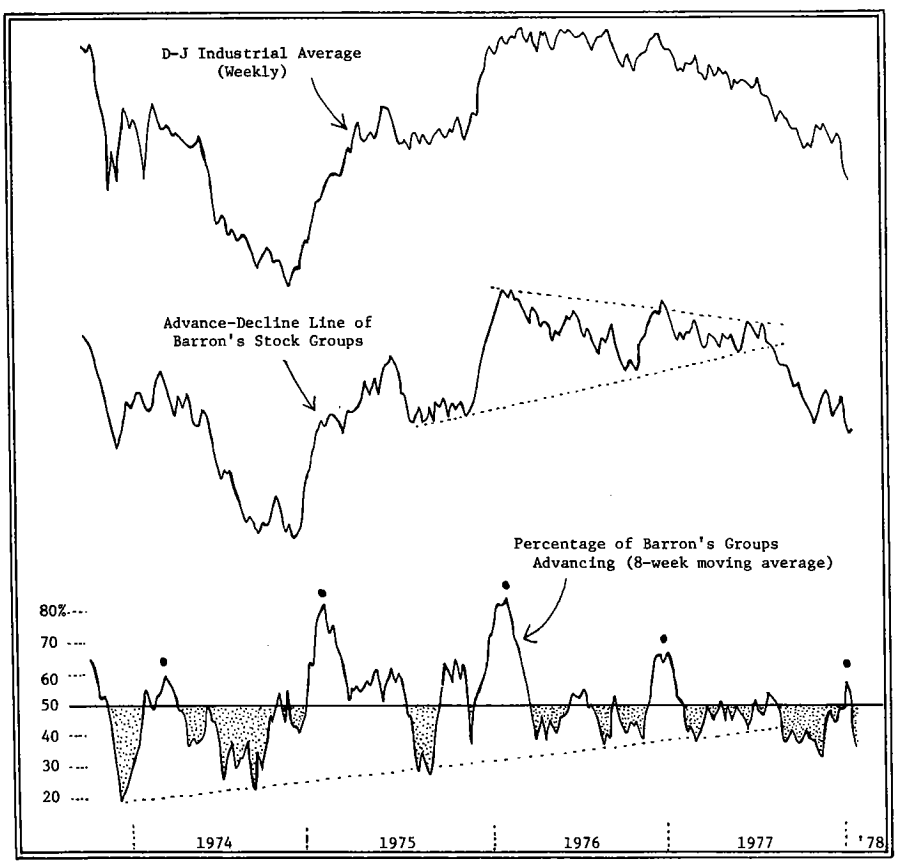
pocketbook from higher Social Security taxes, from rising interest rates and costs in carrying his own debts, and from the inflation in the prices of the items he needs to sustain himself and his family.

It's a strange thing, but most people don't realize this fact: a man can get rid of his car, he can get rid of his house and his yacht and his country club, he can get rid of his golf clubs, his cigarette habit or his second car, but he can't get rid of this debts. They stay with him, and they have to be serviced or paid off. The exact same set of facts apply to a business or a government. It can cut down on expenses, but it can't get rid of its debts.

I think the market is looking ahead, and I think the market sees the debt structure of this nation as a giant problem, a problem that is not going to be solved in a month or a year. And it's not a problem that our President or our Treasury Secretary can talk away. They can't even inflate it away (although they try). The sky-rocketing debt structure is like a giant cancer, eating away at the heart of capitalism. And the market just doesn't want to ignore that any longer.

Harvey: All right, but the debt has been high for years. What's so pressing about 1978's new record levels of debt? Every year records a new debt record.

Rock: Well, I think the debt syndrome is now affecting individual spending and corporate profits. The rising money rates and the rising level of debt is beginning to put a squeeze on profits, and my guess is that the situation is going to get worse as the year goes on. Overseas nations are in a gathering slump, and this is going to hit those fat profits which so many large American firms depend on. In my opinion, the current world-wide "stag-flation" is going to turn into "squeeze-flation." The market knows it–and it's protecting itself accordingly.



Harvey: It's all very interesting, Rock. But my data shows that the market is getting somewhat over-sold now, and I'm getting a bit interested in picking up a few bargains. After all, as of last week the average yield on the Dow finally hit 6%–for the first time on the entire decline. That's been a bargain level for the stock market over the years.

Rock: You see, that's what I'm talking about. This complacency, the kind that you're exhibiting, is *extending* the market decline. If the market rallies here, it simply means that the big bottom, the major bottom I've been talking about will come in May or June or who knows–even September. But my work just doesn't indicate that we're at a major bottom in this area. And I'm not about to gamble my hard-earned, after-tax dollars on a one or two month pop to another over-bought peak. I'm going to wait for the real McCoy. All my data says that with patience the big buy spot is coming in 1978–somewhere along the line.

Harvey: Rock, how about the tax cut that Carter's going to give us? Maybe that will stimulate the economy and the market into a real turnaround.

Rock: That tax cut, and it will probably be over $30 billion before its through, won't help us. The fact is that it only amounts to 1% of the total goods and services of the country. What it will do, however, is help us to produce an unbelievable new deficit–maybe $80 to $90 billion or more for 1979. Look, this bear market has already wiped out $115 billion in market values since the 1977 peak. A bear market can wipe out values faster than Congress can produce tax cuts. What I'm looking at now, Harvey, are those giant Dow stocks like Sears, General Motors, General Electric, Telephone, Union Carbide, all hitting the new low lists. I'm wondering how long it will be until the rest of the market sees what those stocks are seeing. The answer, Harvey, will probably dawn on us later this year, and it's not going to be a pleasant answer.

Harvey: Rock, I don't know if you're scaring me or wearing me out. Let's cool it here and cease the debate. After all, if we don't get it together, Russell's going to have another one of those sleepless nights. And I hate it when he types those blasted pieces at 3 a.m. Even his dogs can't sleep.

STOCK GROUPS: The study of stock groups is an important and revealing study. Whatever factors are affecting an entire group will almost always rub off on the various stocks which make up the group. True, a particular company may far out-perform its group, but as a rule if a group is doing well, most of the stocks within the group will do fairly well, and the converse is also true. For this reason, I watch group action carefully. I like to know *how many* groups are advancing, *what* groups are advancing, and whether the groups are moving with, or diverging with, the major stock averages.

The following is a study that I have not up-dated since Letter 680. The study is based on the 34 stock groups which appear in *Barron's* each week. I tabulate the number of these groups which advance each week, convert this into a percentage of advancing groups, I then run the weekly advancing percentages in the form of an 8-week moving average. That is the index you see at the **bottom** of the chart.

The middle index on the chart is even simpler. This is the differential of advancing and declining groups run as a *continuous advance-decline line*. In other words, if, on a given week, 7 more groups advanced than declined, the figure 7 is added to the previous week's total. Thus, the middle index is a continuous A-D line while the bottom index is an oscillator.

Referring to the Group A-D line, this line acted well from the 1974 low to July, 1977. During all that period the index traced out rising bottoms. From the period of early-1976 to July, 1977, however, the index also traced out a series of three declining peaks. A large *triangle* therefore appeared in the index as shown on the chart.

In July, 1977, the index broke out of the triangle on the downside. More recently, the Group A-D also broke below support at the late-1975 lows. The Group A-D line has thus turned quite bearish, and the trend of *Barron's* 34 stock groups is decisively down.

The oscillator at the bottom of the page is rather interesting. I have placed a black dot at the peak of each peak-bullish period, the period when the percentage of advancing groups recorded its peak. Note that these dots (peaks) tend to appear at about 9-14 month intervals, with peaks tending to appear very early in the year or in the first quarter.

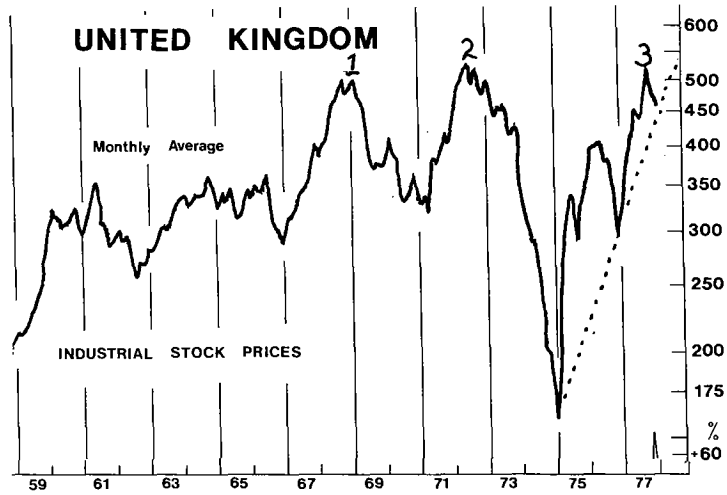
The strength of the peaks often gives us indications of things to come. For instance, the early-1974 peak fell just short of 60% bullish. This was followed by the massive slide into the last quarter of 1974. The 1975 and 1976 peaks both registered above 80%, and both were followed by stronger markets. The early-1977 peak came at a rather low 68%, and this was followed by a gently rising A-D Ratio on the NYSE but a falling Dow. The early 1978 signal registered only 57%, and so far 1978 has seen a very poor market.

Another interesting phenomenon is the three-and-one-half year rising trendline connecting the lows on the bullish percentage index. The late 1977 weakness finally violated this trendline. This confirmed the breakdown in the triangle in the Group A-D line above. Thus, I would say that we are seeing more weakness in the *Barron's* groups now than at any time since 1974.

The pattern of this index over the last four years is that following the peak of group strength in the early months of the year, the greatest weakness arrives during the middle to the late part of the year. Whether that is to be the pattern of 1978 remains to be seen. I had thought that the lows for 1978 might be seen during the first or second quarter, which is at variance with this chart. I still feel, however, that we could hit an important bottom for this market somewhere between March or June. But as older subscribers know, Wall Street doesn't always position itself for Richard Russell's benefit.

LONDON BRIDGE IS . . . . There's a time-honored relationship which operates as follows: the US stock market tends to bottom before the London market (since the US is a stronger economy), and the London market tends to top before the US market (because London is a weaker economy). But today, in this area, we have another most unorthodox situation.

Note on this chart (courtesy of the *Bank Credit Analyst*) that the London market boomed up to a peak of 549.2 on September 14, 1977, despite the fact that the Dow had topped out a year earlier! The strength in London just never rubbed off on the Dow



as "it should have" (classically we should have expected a new Dow high beyond any peak in London).

Now London is coming down, and at last week's figure of 458, my feeling is that the London market has topped out. As you can see on the chart, London has formed an ominous "triple top" at the 1967, 1971 and 1977 highs. The rising trendline for the entire advance comes in at about 450. If London closes under 450 my feeling is that Britain's market is saying "trouble ahead." But here is the question–if a strong London market did not signal "up" for the Dow, what does today's crumbling London market say for the Dow? There's no way I can interpret London's action bullishly–for their market or ours.

NOTES & QUOTES: Much has been made of the marvelous "currency swaps" with which the US manipulates the dollar on the foreign exchange markets. The swaps work this way: the Fed borrows say Swiss francs and sells them in the foreign exchange markets. This has the effect of pressuring Swiss francs to the downside against dollars. Francs (hopefully) then go down while dollars go up. But the swaps are usually arranged on a three-month basis; and they may or may not be renewed. All of this is obviously not a fundamental procedure, it is manipulation. If you or I did it in terms of a stock (or stocks) on the NYSE, the SEC would very likely have us heading toward the nearest Federal prison.

At any rate, that's the bright side of the swaps picture. The dark side is seldom discussed. But here it is: if the Fed lends out dollars to buy say German marks, it has to pay those marks back. Now if the mark is higher at the end of three months, it's going to cost the Fed more to buy back those marks. Do you want to know the record of the Government over the past seven years, in terms of its foreign exchange trading? Here it is: 1971 showed a US loss of $8 million, 1972 a loss of $51 million, 1973 a loss of $47 million, 1974 a loss of $34 million, 1975 a loss of $242 million, 1976 a loss of 25 million, 1977 a loss of $146 million. Total loss to prop up the dollar since 1971: half a billion dollars. And what was the result: the dollar is near a post-War low. Moral No. 1: in due time, fundamentals will overcome any and all manipulation. Moral No. 2: The Government never learns.

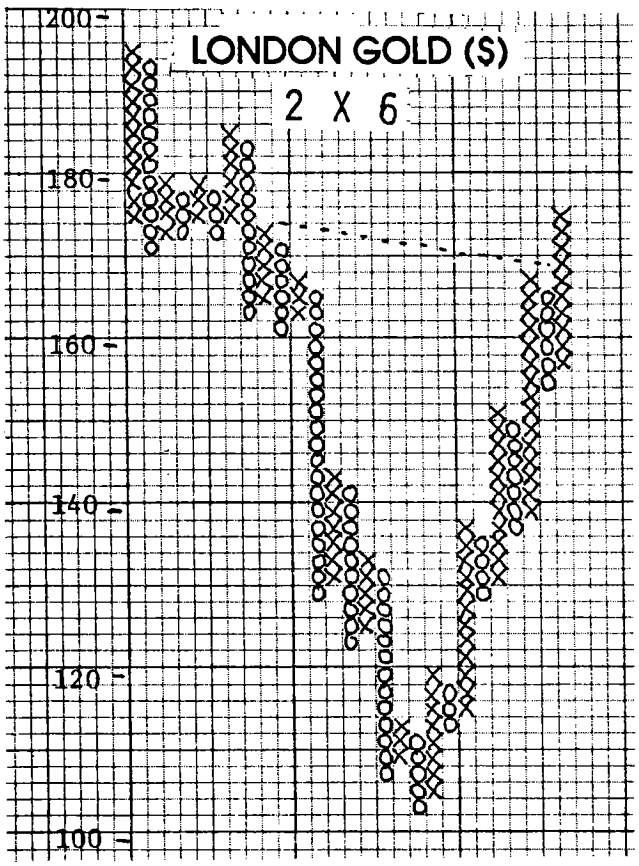
* *

I think too much has been made of "the January barometer," but just for the record the S&P 500 lost 6.2% in January, 1978. This was the third worst performance since 1950, the worst being 1970's 7.6% loss, and the next being 1960's 7.1% loss. Since 1950 we have had 11 previous down-Januarys. Of the 11 years producing a down-January, 9 showed losses for the full year.

GOLD: Here's one factor that I see militating towards higher gold prices in 1978. The "Carter tax cut" is just not going to work without an expansive monetary program. The effects of the Social Security tax boost and rising prices will nullify any benefits from the tax cut, so it will be a rapidly rising money supply that the Administration will be opting for. If the money supply does not expand fast enough (particularly in view of the huge Government financing slated for 1978-79), interest rates are going to go through the roof.

And that's the reason why Carter gave Arthur Burns his walking papers. He could not count on Burns to open the spigots as interest rates rise. Personally, I think the Fed under Miller will choose a rip-roaring expansion in the US money supply—rather than let interest rates rise. When the money supply soars, inflation will heat up and more and more people will attempt to protect themselves with gold. As weakening dollars chase gold, the dollar price of gold will rise. And that's the scene I see ahead.

On top of that, dollar holdings at Foreign Official Institutions such as central banks has climbed to an historic high of over $130 billion. These institutions have to be getting progressively more nervous about what they see happening here in the US. In due time, they will hedge their dollar "bets" by buying gold. I believe we will see this occurring before 1978 is out.



Noting the astronomical pile-up of dollars, the London Economist of January 28 made this comment. *"The (dollar) holdings here are not just the $500 billion in the Eurodollar market and the $100 billion in the US owned by non-residents. Since America has no real mechanism for imposing sudden exchange controls, one might add in also the dollars owned by Americans who might become nervous about their own currency. A decision by the owners of these dollars to convert just 1% of them into other currencies or gold would cause the biggest exodus across the exchanges ever seen."*

The price action in gold continues to be very careful but, I think, good. The point and figure chart below (idea via Tony Henfrey of S. Africa and Jon Strebler of San Diego) is a 2X6 affair, with each box representing 2 points for gold and only rallies or declines of 6 points or more shown. Thus we have a very concentrated picture of gold over the past few years.

I continue to see all the recent action as part of a huge base for the metal, with an ultimate price target well into the mid 240's or higher. Actually, gold could work sideways between the recent high of 177 and a low of 162, thus building a "right shoulder," and still look very strong. I realize that such a bullish consolidation, however, would not make rooters for the metal happy. But it would be very constructive, if it occurs. Advice: continue to buy the coins (or bullion from your broker) in this area up to 10 to 20% of available assets. Then be patient.

The dollar has been acting better ever since 1978 started, but gold (contrary to the widespread forecast) has held up or pushed higher. I continue to believe that any real weakness in the hard currencies will find holders of those currencies switching to dollars AND gold. Thus, gold would be moving up along WITH a rallying dollar.

LATE NOTES: I get this feeling of "madness," of extremes being built into the economy and the markets. I see the possibility of a $100 billion deficit coming up in 1978, I see the record numbers of dollars piling up around the world. I see the record margin debt on the NYSE, and I understand that this margin money has gone into houses, cars, stocks, you name it. People have spent it "up to here" in what appears to be an almost insane flight from liquidity and solvency.

Meanwhile, the "moving finger writes," and it is writing about a developing squeeze in the money markets. The recent rally on my bond charts has been pitifully weak. In three weeks of trying, the Treasury 8's of 1996 have been able to rise only ½ point from their low. Now they appear ready to turn down again. If that happens, money rates are going to rise another notch. Meanwhile, most of the bearish analysts (I include myself) have latched on to the idea of a Dow rally "to 800 or better." I'm beginning to wonder whether we'll see even that kind of near-term strength. As of this writing, the Dow looks as weak as it has all year. I continue to advise a position of 80% to 85% Treasury bills—with the rest in gold.

NEXT MAILING: February 17th